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CHECK FRAUD AND THE VARIATION OF SECTION 4-401: WHY BANKS SHOULD NOT BE ABLE TO VARY THE UCC'S STANDARD RISK ALLOCATION SCHEME

Abstract: Uniform Commercial Code Article 4 governs both a bank's duties in collecting checks for payment as well as its duties to its depositors. Section 4-401 provides that a bank can charge an item to a customer's account only if it is properly payable. For an item to be properly payable, it must be authorized by the customer. This Note examines the 2010 case, *Cincinnati Insurance Co. v. Wachovia Bank*, in which the U.S. District Court for the District of Minnesota stated that a bank can vary section 4-401's default rule by including negotiated provisions in the deposit agreement. After exploring the structure and history of Article 4, this Note argues that banks should not be able to vary section 4-401's default rule, and proposes that courts take into account the history of Article 4 when analyzing which default rules banks can vary through deposit provisions.

INTRODUCTION

Frank Abagnale, one of the most prolific check forgers in U.S. history, once wrote, "I was a millionaire twice over and half again before I was twenty-one. I stole every nickel of it."¹ He started in 1964 at age sixteen, and within five years managed to bilk banks and companies out of \$2.5 million.² Abagnale accomplished much of his fraud by producing checks that looked exactly like the payroll checks for Pan Am.³ Under the Uniform Commercial Code (the "UCC" or "Code"), Pan Am's bank was forced to bear the losses from these fraudulent checks because they were not authorized by Pan Am.⁴

¹ FRANK W. ABAGNALE, CATCH ME IF YOU CAN 4 (2000); *Top 10 Imposters: Frank Abagnale*, TIME LISTS, http://www.time.com/time/specials/packages/article/0,28804,1900621_1900618_1900788,00.html (last visited Jan. 21, 2013).

² *Id.* at 4–5, 21.

³ *Id.* at 118–19. Pan American World Airways (Pan Am) was a major airline carrier during the 1960s. *Id.*

⁴ U.C.C. § 4-401 (2002) (providing that checks that are not properly payable cannot be charged to a customer's account); *id.* § 4-401 cmt. 1 (providing that an unauthorized drawer's signatures cannot be properly payable).

The risk of loss for check fraud is governed by various provisions in Articles 3 and 4 of the UCC.⁵ Article 3 governs negotiable instruments, of which checks are a subset.⁶ Article 4 provides a comprehensive set of rules for the check system among banks and for the collection of checks.⁷ Within this system, the UCC contains a standard risk allocation scheme that requires payment system providers (banks) to bear the risk of loss for fraudulent checks.⁸ Only in the case of user negligence can a bank seek to enforce a fraudulent check on a customer.⁹

The check system stipulates that the account holder is the drawer of a check on a bank, which is the drawee, that is made payable to a payee.¹⁰ To collect a check, Article 4 requires the payee to bring the check to a depository bank to deposit it for a credit to the payee's account.¹¹ Then, the depository bank either will present the check to the payor bank or will transfer it to an intermediary bank, which then will present it through a chain of collecting banks to the payor bank.¹² The drawee bank, under Article 3, is also the payor bank, under Article 4, because it will make the decision whether to pay the check or dishonor it.¹³ The payor bank is also the depository bank of the check's drawer.¹⁴

In his book, *Catch Me If You Can*, Frank Abagnale described a scheme that he commonly used to defraud banks:

I made myself, "Frank Williams," the payee, of course in the amount of 568.10, a sum that seemed reasonable to me. In the lower left hand corner I type in "Chase Manhattan Bank" and the bank's address. . . . Below the bank legend, across the

⁵ See *id.* §§ 3-405, 3-406, 3-416, 4-401.

⁶ *Id.* §§ 3-102, 3-104.

⁷ *Id.* § 4-101 cmt. 1.

⁸ *Id.* § 4-401 (providing that banks can charge their customers only for checks that are properly payable).

⁹ *Id.* § 4-406(d). A customer who fails to exercise reasonable promptness in examining a statement will be precluded from asserting against the bank that there was (1) an unauthorized signature or alteration if the bank proves it suffered a loss by reason of the failure, and (2) the unauthorized signature or alteration by the same wrongdoer on any item the bank paid in good faith before the bank received notice from the customer of the unauthorized item. *Id.*

¹⁰ U.C.C. § 3-103(4) (2002) (defining "drawee" as the person ordered to make payment); *id.* § 3-103(5) (defining "drawer" as the person who signs ordering payment).

¹¹ See JAMES STEVEN ROGERS, *THE END OF NEGOTIABLE INSTRUMENTS: BRINGING PAYMENT SYSTEMS LAW OUT OF THE PAST* 125-26 (2011).

¹² See *id.*

¹³ U.C.C. § 4-402(c) (allowing a payor bank to determine a customer's balance at any point between the time it receives the item and the time it returns the item as dishonored).

¹⁴ *Id.* § 4-401.

bottom left hand corner of the check, I laid down a series of numbers. . . . The numbers purportedly represented the Federal Reserve District of which Chase Manhattan was a member, the bank's FRD identification number and Pan Am's account number. . . . I drove to the nearest bank, walked in jauntily and presented myself at a teller's booth. . . . "Would you cash this check for me? I think that I have sufficient identification."¹⁵

In Abagnale's example, Frank Williams is the payee, Pan Am is the drawer, and Chase Manhattan Bank is both the payor and drawee bank, where the check would ultimately be presented.¹⁶ When Frank signs the check in order to have the check cashed, that is Frank's indorsement.¹⁷ The teller, of course, cashed the forged check.¹⁸

As Abagnale continued, his frauds became more complex and expensive.¹⁹ Abagnale eventually bought a real Pan Am payroll check from a flight attendant, brought it to a check printer, and ordered exact duplicates of Pan Am checks.²⁰ This example demonstrates the potential costs of fraud in the check system—costs that banks are proposing to transfer to their depositors via provisions placed in the deposit agreements.²¹

Article 4 of the UCC governs the relationship between a depository bank and its depositor customer, including establishing who is liable for fraudulent and unauthorized checks.²² Section 4-401 provides that a depository bank can only debit a customer's account for a check if it is "properly payable."²³ Comment 1 to section 4-401 provides that any check that is not authorized by the drawer (alterations to the check are not authorized) is not "properly payable."²⁴ If the item is not properly

¹⁵ ABAGNALE, *supra* note 1, at 118–20.

¹⁶ See U.C.C. §§ 3-103(4), 4-105(3) (2002); ABAGNALE, *supra* note 1, at 118–20.

¹⁷ See U.C.C. § 3-204(a) (providing that an indorsement is a signature on an instrument meant to negotiate the instrument).

¹⁸ ABAGNALE, *supra* note 1, at 119.

¹⁹ See *id.* at 166–70.

²⁰ *Id.*

²¹ See *id.* at 168–69.

²² U.C.C. § 4-401 (2002).

²³ *Id.* ("An item is properly payable if it is authorized by the customer and is in accordance with any agreement between the customer and bank.").

²⁴ *Id.* § 4-401 cmt. 1 ("An item containing a forged drawer's signature or forged indorsement is not properly payable.").

payable, then the bank is not entitled to charge the item to the customer's account.²⁵

The relationship between the depositor and its bank has always been considered a creditor-debtor relationship.²⁶ Specifically, cases interpreting the UCC historically have held that it was the bank's duty to honor proper checks drawn upon it unless the bank had a right to refuse the order by reason of another agreement.²⁷

Over the years, banks have attempted to modify the UCC's default rules in order to pass liability on to their depositors through provisions in their deposit agreements.²⁸ Recently, banks have attempted to change the default rules of UCC section 4-401 by adding language to their customers' deposit agreements.²⁹ This practice has raised the question of whether banks may use these types of provisions to alter the default rules, and if so, to what extent.³⁰ UCC section 4-103 provides that the UCC's default rules may be varied by agreement so long as the bank does not disclaim ordinary care.³¹ This provision poses the question of what the duty of ordinary care involves in the setting of a creditor-debtor relationship.³²

This issue was presented in the 2010 case, *Cincinnati Insurance Co. v. Wachovia Bank*, in the U.S. District Court for the District of Minnesota.³³ At issue in the case was whether Wachovia could charge back to its customer a check that had been altered.³⁴ The court held that a provision in the deposit agreement that shifted liability onto the depositor

²⁵ James Steven Rogers, *The Basic Principle of Loss Allocation for Unauthorized Checks*, 39 WAKE FOREST L. REV. 453, 455 (2004).

²⁶ *Tex. Commerce Bank-Hurst v. United States*, 703 F. Supp. 592, 594 (N.D. Tex. 1988); *Mallett v. Tunnicliffe*, 136 So. 346, 348 (Fla. 1931); *Caledonia Nat'l Bank of Danville v. McPherson*, 75 A.2d 685, 687 (Vt. 1950).

²⁷ *Mallett*, 136 So. at 349; *Caledonia*, 75 A.2d at 687 (stating that according to the majority of cases, the bank gives the depositor a right to draw on the credit).

²⁸ *See, e.g., Perini Corp. v. First Nat'l Bank of Habersham Cnty.*, 553 F.2d 398, 400 (5th Cir. 1977) (attempt to push liability on to the depositor for unauthorized checks that bore the facsimile signature); *Cincinnati Ins. Co. v. Wachovia Bank*, No. 08-CV-2734, 2010 WL 2777478, at *1 (D. Minn. July 14, 2010) (attempt to pass fraud losses to depositor if depositor did not pay for positive payment); *Mercantile Bank of Ark. v. Vowell*, 117 S.W.3d 603, 612 (Ark. Ct. App. 2003) (attempt to limit the time depositors have to challenge unauthorized items).

²⁹ *See Cincinnati Ins.*, 2010 WL 2777478, at *4 (explaining the effects of positive payment on the default rules in section 4-401).

³⁰ *See, e.g., Perini*, 553 F.2d. at 400.

³¹ U.C.C. § 4-103 (2002).

³² *See id.*

³³ *See Cincinnati Ins.*, 2010 WL 2777478, at *4 (explaining the effects of positive payment on the default rules in section 4-401).

³⁴ *Id.* at *1.

was enforceable.³⁵ This outcome resembles that of our Frank Abagnale example—he was able to reproduce Pan Am checks without any negligence on the part of Pan Am and yet, under the wording of the contractual provisions, the liability would be shifted from the bank to the depositor (Pan Am).³⁶

The *Cincinnati Insurance* holding has produced a legal dilemma: if a bank does not have to repay its depositor as directed, what is the relationship between the bank and depositor?³⁷ Although section 4-103 states that a bank can vary any provision within Article 4 by agreement of the parties so long as the bank does not disclaim ordinary care, the term “ordinary care” in the context of a depositor- or creditor-debtor relationship is not defined.³⁸ There are two possible reasons for this result: (1) the Code’s drafters were looking at deposits in the context of the historical relationship of the depositor/creditor to the bank/debtor, or (2) most of Article 4 is concerned with the collection of checks, and part 4 of the Article was added to the old bank collection statutes without considering how section 4-103 would relate to section 4-401.³⁹ Both of these answers lead to the conclusion that section 4-103 should not be applied to vary what can be charged to a depositor’s account.⁴⁰

This Note evaluates whether deposit agreement provisions that vary the properly payable rule in section 4-401 are enforceable.⁴¹ Part I discusses the history of Article 4, the standard risk allocation scheme, and the regulation of the relationship between a bank and its depositor.⁴² Part II provides context to the discussion by analyzing variations of other provisions in Article 4, and then compares them to the variation of section 4-401.⁴³ Part III then argues that courts should not allow variation of section 4-401 because it is inefficient, undercuts the common law duties of banks, and was not meant to apply to section 4-401.⁴⁴ Part III also proposes that courts should give due regard to the histori-

³⁵ *Id.*

³⁶ ABAGNALE, *supra* note 1, at 166–70; *see Cincinnati Ins.*, 2010 WL 2777478, at *1, *4.

³⁷ *See Cincinnati Ins.*, 2010 WL 2777478, at *4; *Tex. Commerce*, 703 F. Supp. at 594; *Mallett*, 136 So. at 348; *Caledonia*, 75 A.2d at 687.

³⁸ *See* U.C.C. § 4-103 (2002) (failing to define “ordinary care”).

³⁹ *See Tex. Commerce*, 703 F. Supp. at 594; *Mallett*, 136 So. at 348; *Caledonia*, 75 A.2d at 687.

⁴⁰ *See infra* notes 302–346 and accompanying text.

⁴¹ *See infra* notes 46–346 and accompanying text.

⁴² *See infra* notes 46–123 and accompanying text.

⁴³ *See infra* notes 124–190 and accompanying text.

⁴⁴ *See infra* notes 191–346 and accompanying text.

cal duties of depository banks when confronted with section 4-401 variation issues.⁴⁵

I. THE HISTORY OF ARTICLE 4: HOW THE UNIFORM COMMERCIAL CODE BECAME A WEAPON FOR BANKS

This Part provides a background of Article 4's standard risk allocation scheme and the policies behind check fraud loss allocation, which is necessary to understand whether provisions that vary the default rules of section 4-401 are enforceable.⁴⁶ Section A details the history of Article 4 and describes how its predecessor, the Bank Collection Act, affected its provisions and formation.⁴⁷ Section B explains how Article 4 establishes a standardized scheme for the allocation of losses due to fraudulent checks.⁴⁸ Section C discusses the provisions that govern the relationship between a depository bank and its customers and the problem posed by the variation of section 4-401.⁴⁹

A. *The History of Article 4 and Its Predecessor, the Bank Collection Act*

Article 4 of the UCC came about primarily as a solution to the problems that existed in a national check collection system.⁵⁰ Before the creation of Article 4, the law was unclear about the duties of a bank in the collection of checks.⁵¹ Different states had different standards for banks in collection.⁵² In some states, banks were considered agents of the depositor and were ultimately tasked with obtaining payment of the check for the depositor.⁵³ If a collecting bank was an agent of the depositor, then, under agency law, the depository bank was not liable to its account holder if it did not receive payment for the check due to a bank failure in the collection chain.⁵⁴ Other states took the view that collecting banks were agents of the depository bank, and therefore pro-

⁴⁵ See *infra* notes 191–346 and accompanying text.

⁴⁶ See *infra* notes 65–123 and accompanying text.

⁴⁷ See *infra* notes 50–64 and accompanying text.

⁴⁸ See *infra* notes 65–95 and accompanying text.

⁴⁹ See *infra* notes 96–123 and accompanying text.

⁵⁰ ROGERS, *supra* note 11, at 131; John M. Norwood, *Charge-Back Rights of Collecting Banks*, 113 BANKING L.J. 360, 361 (1996).

⁵¹ ROGERS, *supra* note 11, at 129; see Norwood, *supra* note 50, at 361.

⁵² ROGERS, *supra* note 11, at 129.

⁵³ *Id.*

⁵⁴ *Id.*

vided depositary account holders with more rights against their bank if a problem in collection resulted in non-payment of a check.⁵⁵

In the 1920s, the American Banking Association (“ABA”) began to support the creation of a uniform law for check collection procedures, which eventually became the ABA Bank Collection Code (“the ABA Code”).⁵⁶ The ABA Code supported the Massachusetts rule, which viewed collecting banks as agents of the depositor.⁵⁷ The ABA Code was ultimately defeated when numerous states refused to pass it into law because they felt that it was too favorable to banks.⁵⁸ In the early 1950s, after the ABA Code’s defeat, a second effort to develop a uniform collection code led to the creation of Article 4 of the initial UCC.⁵⁹

At the time of the adoption of Article 4, there was significant debate around whether the depositary bank should be liable for failure to receive payment due to a problem in collection.⁶⁰ Harsh criticism came from a prominent commentator, Frederick Beutel, that Article 4 gave too much power to banks by allowing them to avoid liability for non-payment due to a problem in collection.⁶¹

During the process of revising the ABA Code into Article 4 of the UCC, the drafters felt that it was necessary to include provisions governing the relationship between a bank and its customer.⁶² Almost as an afterthought, provisions governing the depositor-bank relationship were included as part IV of Article 4.⁶³ Therefore, the provisions in part IV seem to be lumped into Article 4, without much thought as to the

⁵⁵ *Id.*

⁵⁶ *Id.* at 130; Norwood, *supra* note 50, at 361.

⁵⁷ ROGERS, *supra* note 11, at 130; Norwood, *supra* note 52, at 361 (stating that the ABA Code included a provision that the bank was the agent for the depositor in collection).

⁵⁸ See ROGERS, *supra* note 11, at 131; Norwood, *supra* note 50, at 361 (noting that fewer than half the states adopted the ABA Code). The states’ concern was valid as it was the intent of the ABA Code to place the risk of loss for uncollected items on the customer. See Norwood, *supra* note 50, at 362.

⁵⁹ ROGERS, *supra* note 11, at 131.

⁶⁰ See ROGERS, *supra* note 11, at 131; Frederick K. Beutel, *The Proposed Uniform [?] Commercial Code Should Not Be Adopted*, 61 YALE L.J. 334, 360 (1952) (stating that proposed Article 4 was too bank friendly and was in fact class legislation); Grant Gilmore, *The Uniform Commercial Code: A Reply to Professor Beutel*, 61 YALE L.J. 364, 377 (1952) (agreeing with Professor Frederick Beutel that if section 4-103, the provision that permits banks to vary the default rules, was not deleted, then Article 4 should not be adopted).

⁶¹ Beutel, *supra* note 60, at 359–60. Conspicuously, Professor Grant Gilmore, who was strongly against section 4-103 because he felt it might completely diminish any responsibility a bank might have to a customer in collection, did not even mention the potential effect 4-103 might have on what is properly payable. Gilmore, *supra* note 60, at 376–77.

⁶² ROGERS, *supra* note 11, at 143–44.

⁶³ *Id.*

differences between the actions of payor banks on behalf of their customers and those of collecting banks; this is apparent in the late addition of these provisions and the absence of common law duties of a bank to its customer in the provisions.⁶⁴

B. The Interplay Between Article 3 and Article 4: The Risk Allocation Scheme

Article 3 of the UCC governs negotiable instruments, of which checks are a subset, whereas Article 4 governs the collection of checks for payment and the duties of a bank to its customer.⁶⁵ A bank's customer in this situation is the person who has a depository account at the bank.⁶⁶ Although the customer will go to the bank in order to deposit checks, section 4-401 is concerned with checks that are drawn on a customer's account and presented for payment.⁶⁷

As noted in the Introduction, a customer who writes a check is the drawer of the check and the customer's bank is the drawee.⁶⁸ The payee will bring the check to his or her bank, which is both the depository bank in the chain of collection as well as the payee's depository bank.⁶⁹ In order for the payee to obtain payment for the check, the payee's depository bank must forward the check through collection.⁷⁰ Collection may, in the easiest manner, involve sending the check directly to the drawer's bank.⁷¹ This scenario is common for major banking institutions.⁷² For smaller banks that are distant from the payor bank, however, the path may be much more complicated with the check passing through multiple banks.⁷³ Article 4 labels these intermediaries as collecting banks.⁷⁴ A collecting bank grants a provisional settlement credit, upon receipt of the check, to the previous bank in the chain.⁷⁵ Ulti-

⁶⁴ See *id.*; see also Gilmore, *supra* note 60, at 376–77 (noting the ability of banks to contract out of the statute via section 4-103 in collection, but not mentioning anything about the definition of properly payable).

⁶⁵ U.C.C. §§ 3-102, 4-102 (2002).

⁶⁶ *Id.* § 4-401.

⁶⁷ See *id.*

⁶⁸ *Id.* §§ 3-103(a) (5) (defining a “drawee” as a person ordered to make a payment), 3-103(a) (6) (defining a “drawer” as a person who signs or orders payment); *supra* notes 15–21 and accompanying text.

⁶⁹ *Id.* § 4-105 (defining a depository bank as the first bank to take an item in collection).

⁷⁰ *Id.* § 4-201.

⁷¹ See U.C.C. § 4-204 (2002) (stating that a collecting bank may send a check directly to a payor bank).

⁷² See *id.* § 4-204 cmt. 2.

⁷³ See *id.* § 4-204(b).

⁷⁴ *Id.* § 4-105(5).

⁷⁵ *Id.* § 4-202.

mately, the check will be presented for payment to the payor bank, which is also the depository bank of the check drawer.⁷⁶ Unless the payor bank takes an affirmative action within the prescribed timeline, all the provisional settlements in the chain will become final.⁷⁷ Errors in this collection process are what most of Article 4 is structured to govern and why Professors Frederick Beutel and Grant Gilmore were concerned that Article 4 would enable banks to create a set of rules that would insulate them from any liabilities stemming from the collection chain.⁷⁸

The interplay between Article 3 and Article 4 creates a standard risk allocation scheme whereby a payor bank will be liable for any forged indorsement unless it can show certain types of negligence committed by its depository customer, the presumed drawer of the check.⁷⁹ The UCC's standard risk allocation system provides that the drawee bank is responsible for the loss due to a forged drawer's signature, whereas the depository bank is ultimately liable for a forged indorser's signature.⁸⁰ Where only the amount of money on the check is altered, the drawee and payor bank can charge its customer for the amount originally authorized while the original depository bank in the chain of collection will bear the risk of loss of the difference between the altered check and the original payment.⁸¹ Returning to the Frank Abagnale example, which involved an unauthorized drawer's signature because Abagnale signed Pan Am's facsimile signature onto the check, the payor bank, which was Pan Am's bank, Chase Manhattan Bank, would have had to bear the loss.⁸² In contrast, had Abagnale stolen a check payable to Pan Am and indorsed the check as Pan Am, this would have constituted a forged indorsement, and thus the depository bank in collection would have been liable.⁸³

⁷⁶ *Id.* § 4-105(3) (defining "payor bank" as the bank that is the drawee of a check).

⁷⁷ U.C.C. § 4-215 (2002).

⁷⁸ Beutel, *supra* note 60, at 359–60; Gilmore, *supra* note 60, at 376–77; see U.C.C. § 4-101 (indicating that the title of Article 4 is "Bank Deposits and Collections").

⁷⁹ U.C.C. §§ 3-405, 3-406, 4-207, 4-208.

⁸⁰ *Id.* §§ 4-207, 4-208 (providing that transferring and presenting banks warrant that an instrument has no forged indorsements and that the draft has not been altered). The result, when combined with section 4-401, is that the depository bank bears the loss for forged indorsements whereas the payor bank bears the loss for forged drawer's signatures. See *id.* § 4-401; *supra* note 17 (defining "indorsement").

⁸¹ See U.C.C. §§ 4-208, 4-401.

⁸² See *id.* §§ 3-103(5), 4-208; *supra* notes 15–21 and accompanying text.

⁸³ See U.C.C. §§ 3-204(a), 4-207 (2002).

Banks have defenses against their customers whose lack of ordinary care causes a loss.⁸⁴ Article 3, which governs the transfer and payment of checks as a subset of negotiable instruments, provides multiple defenses for banks in situations in which a customer may bear some of the blame for the loss.⁸⁵ Section 3-405 provides that an employer can be responsible for the fraudulent indorsement of one of its employees.⁸⁶ “[I]f [the] employer entrusted the employee with responsibility with respect to that type of instrument,” and the employee made a fraudulent indorsement, the indorsement is effective against the employer.⁸⁷ If the party that paid value for the instrument failed to exercise ordinary care, then a comparative negligence scheme determines the damages.⁸⁸

If a party’s failure to exercise ordinary care contributes to the alteration of an instrument or the forging of a signature, then that party is precluded from bringing an action against the bank for repayment.⁸⁹ If the party arguing that the item should be precluded (in the usual case, it will be the payor bank against its creditor account holder) also failed to exercise ordinary care, then a comparative negligence scheme is used to determine the damages.⁹⁰

Section 3-417 also provides a warranty for the payor bank for paying over forged instruments.⁹¹ If the payor bank pays a check that is unauthorized, then the payor bank can recover the damages that resulted from the breach of warranty minus the amount that can be recovered from the drawer.⁹² Article 4 of the UCC provides a parallel warranty for payor banks, with substantially the same provisions and protections as in Article 3.⁹³

⁸⁴ *Id.* §§ 3-405, 3-406, 3-416.

⁸⁵ *Id.* §§ 3-405, 3-406, 3-416.

⁸⁶ *Id.* § 3-405.

⁸⁷ *Id.* An example of an employee “with responsibility with respect to that type of instrument” would be an employee in an accounts payable department who has access to the corporate checkbook in order to pay recurring bills. *See id.*

⁸⁸ *Id.* § 3-405(b).

⁸⁹ U.C.C. § 3-406 (2002).

⁹⁰ *Id.* § 3-406(b).

⁹¹ *Id.* § 3-417. Section 3-417 provides for a presentment warranty such that any person who obtains payment for the instrument warrants that the warrantor is a person entitled to enforce the instrument, that there have been no alterations, and that the warrantor has no knowledge that the drawer’s signature is unauthorized. *Id.*

⁹² *Id.* § 3-417(b).

⁹³ *See id.* § 4-208(a)(1)–(4).

By allowing banks to vary the provisions of Article 4 by agreement, section 4-103 threatens this default system.⁹⁴ A bank, via deposit agreements, is able to change the default rule that the users of the system will be liable even for frauds to which they had no connection.⁹⁵

C. The Relationship Between the Depositor and the Bank and the Issues Posed by the Variation of Section 4-401

Before the adoption of the UCC, the relationship between a depositor and its bank was considered that of a creditor and debtor, with the depositor as creditor and the bank as debtor.⁹⁶ Although there are differences from a typical creditor-debtor relationship, the depositor, as a creditor of the bank, is entitled to repayment as directed by the account holder.⁹⁷ Therefore, prior to the UCC and section 4-401, case law had held that it was the bank's duty to honor checks authorized by the drawer, unless it had a separate right not to pay the check.⁹⁸ The primary right of the creditor-depositor is the ability to order the debtor-bank to disburse funds to the depositor's benefit.⁹⁹ The bank cannot deduct funds from the account except with the authorization of the creditor-depositor.¹⁰⁰ Returning to the Frank Abagnale example, let us assume that Abagnale had a valid payroll check from Pan Am that he deposited into his account at Chase Manhattan Bank.¹⁰¹ If the check was ultimately paid, Abagnale would be entitled to repayment from the bank, usually in the form of a check drawn on his account.¹⁰²

Article 4 of the UCC allows for its provisions to be varied by agreement so long as the bank does not disclaim good faith or ordinary care.¹⁰³ Good faith is defined in section 3-103(a) (6) as both honesty in fact and observance of reasonable commercial standards of fair dealing.¹⁰⁴ Ordinary care is defined as the observance of reasonable com-

⁹⁴ See *Tex. Commerce*, 703 F. Supp. at 594; *Caledonia*, 75 A.2d at 688.

⁹⁵ See, e.g., *Cincinnati Ins.*, 2010 WL 2777478, at *4 (explaining the effects of positive payment on the default rules in section 4-401).

⁹⁶ *Tex. Commerce*, 703 F. Supp. at 594; *Mallett*, 136 So. at 348; *Caledonia*, 75 A.2d at 687.

⁹⁷ See *Caledonia*, 75 A.2d at 688.

⁹⁸ See, e.g., *Mallett*, 136 So. at 349.

⁹⁹ *Tex. Commerce*, 703 F. Supp. at 594.

¹⁰⁰ See *Cross v. Amoretti*, 9 P.2d 147, 148 (Wyo. 1932).

¹⁰¹ See *Cross*, 9 P.2d at 148; U.C.C. § 4-401 (2002).

¹⁰² See *Cross*, 9 P.2d at 148; U.C.C. § 4-401.

¹⁰³ U.C.C. § 4-103(a).

¹⁰⁴ *Id.* § 3-103(a) (6).

mercial standards in the area with respect to the business in which the party is engaged.¹⁰⁵

Banks, through recent developments in deposit agreements with their customers, have attempted to change the default rules in section 4-401.¹⁰⁶ One important change involves the banks' development of positive payment programs for their customers.¹⁰⁷ Positive pay systems help protect both the bank and the customer from fraudulent checks.¹⁰⁸ Under positive pay, customers submit the information of all their checks for the day (including the check number and amount) at the close of business every day.¹⁰⁹ For a monthly fee, the bank will then match the checks presented for payment on the customer's account with the information given by the customer.¹¹⁰ If the check presented for payment does not match the information given by the customer, then the bank will promptly dishonor the check as unauthorized.¹¹¹

Following the development of positive payment systems, a bank could stipulate in its deposit agreement with its business customer that if a customer chose to reject the positive payment system, the customer must accept liability for any forged item, including those for which the customer would not be liable under the standard rule.¹¹² As a result, a legal question arose concerning whether the UCC risk allocation scheme could or should be varied by agreement.¹¹³

Positive payment presented an issue in the 2010 case, *Cincinnati Insurance Co. v. Wachovia Bank*, in which the U.S. District Court for the District of Minnesota held that the deposit agreement provision was enforceable.¹¹⁴ Wachovia wanted to charge back to its depositor, Schultz Foods, a check that had been altered.¹¹⁵ In the deposit agreement, a provision stipulated that if the customer rejected positive payment, then the customer would bear the risk of loss for fraudulent

¹⁰⁵ *Id.* § 3-103(a)(9).

¹⁰⁶ See *Cincinnati Ins.*, 2010 WL 2777478, at *4.

¹⁰⁷ See *id.* at *1; see also Matthew R. Salzwedel, *Toothless Tigers: Positive and Reverse-Positive Pay and the Illusion of Customer-Loss Allocation for Check Fraud*, 126 *BANKING L.J.* 130, 131–32 (2009) (describing how positive payment systems interact with Article 4).

¹⁰⁸ *Cincinnati Ins.*, 2010 WL 2777478, at *1.

¹⁰⁹ *Id.*

¹¹⁰ *Id.*

¹¹¹ *Id.*

¹¹² *Id.*

¹¹³ See *id.* at *3.

¹¹⁴ *Cincinnati Ins.*, 2010 WL 2777478, at *6.

¹¹⁵ *Id.* at *1.

items.¹¹⁶ The court ultimately held that this provision was enforceable because it was not manifestly unreasonable under section 4-103.¹¹⁷

There are competing policy objectives on both sides of the issue of whether banks should be able to vary the properly payable standard.¹¹⁸ Freedom of contract theory argues that banks and their customers should be able to price and allocate risk between them as they see fit.¹¹⁹ Proponents of this theory argue that freedom of contract allows business parties to allocate risk most efficiently.¹²⁰ On the other hand, the UCC framework provides certainty for businesses such that both customers and banks can depend on the same results in different states.¹²¹ Furthermore, clear rules throughout the system serve to minimize litigation between banks and their customers, reducing the costs of doing business for all involved.¹²² Indeed, one of the main reasons for the last comprehensive update of Article 4, in 1990, was to minimize litigation.¹²³

II. DUTIES OF A DEPOSITARY BANK TO ITS CUSTOMERS UNDER UCC ARTICLE 4: PROCEDURAL VERSUS SUBSTANTIVE RIGHTS

Although litigation surrounding banks' ability to vary section 4-401 of the UCC using section 4-103 has only recently come through the courts, multiple analogies to other provisions in Article 4 and creditor-debtor law are available.¹²⁴ Time limitation provisions provide a contextual distinction from provisions that alter 4-401 because they do not affect a depositor's substantive rights.¹²⁵ In comparison, facsimile agreements alter the default rule in 4-401 in a more subtle, limited, and

¹¹⁶ *Id.*

¹¹⁷ *Id.* at *7-8; see U.C.C. § 4-103 (2002).

¹¹⁸ See, e.g., Peter A. Alces & Jason M. Hopkins, *Carrying a Good Joke Too Far*, 83 CHI.-KENT L. REV. 879, 903 (2008) (stating that courts are comfortable assuming sufficient agreement when transactors acted as though they agreed); L. Ali Khan, *A Theoretical Analysis of Payment Systems*, 60 S.C. L. REV. 425, 485 (2008) (arguing that banks are the best loss avoiders and are in a unique position to insure society); A. Brooke Overby, *Check Fraud in the Courts After the Revisions to U.C.C. Articles 3 and 4*, 57 ALA. L. REV. 351, 361 (2005) (stating that the loss allocation provisions promote finality and place the risk on the banking system).

¹¹⁹ Christopher M. Grengs & Edward S. Adams, *Contracting Around Finality: Transforming Price v. Neal from Dictate to Default*, 89 MINN. L. REV. 163, 202 (2004) (arguing that making *Price* or section 4-401 a default rule, instead of an unvariable standard, would allow parties to contract for the most efficient allocation of risk).

¹²⁰ *Id.*

¹²¹ See U.C.C. §§ 4-207, 4-208, 4-401 (2002); Overby, *supra* note 118, at 361.

¹²² See Overby, *supra* note 118, at 361 n.63.

¹²³ *Id.* at 386.

¹²⁴ U.C.C. § 4-103 (2002); see *infra* notes 130-139 and accompanying text.

¹²⁵ See *infra* notes 130-139 and accompanying text.

less harmful manner than the more recent positive payment provisions.¹²⁶ Section A discusses banks' attempts to vary the time reporting requirements for depositors to report unauthorized checks.¹²⁷ Section B explains the use of facsimile provisions in deposit agreements and courts' handling of such provisions.¹²⁸ Section C distinguishes time reporting limitations from both facsimile agreements and positive payment agreements.¹²⁹

A. *The Ability to Vary the Section 4-406 Time Reporting Requirements*

Banks have been successful in modifying the default provision in Article 4 that governs the period of time in which a customer may report fraudulent activity to the bank, by inserting a provision in the bank's deposit agreement.¹³⁰ Article 4 provides that the customer has a year to report fraudulent activity from the time it appears on a bank statement.¹³¹ This provision exposes the bank to a relatively wide band of liability for unauthorized checks that a bank may have paid months before.¹³² Consequently, banks have tried to limit the period of time in which customers may bring a challenge in order to limit their liability.¹³³ For the most part, banks have been successful in their efforts to limit the notification period.¹³⁴

Some courts, however, have refused to permit banks to limit the notification period severely.¹³⁵ For example, in the 2003 case, *Crescent Women's Medical Group, Inc. v. Keycorp*, the Court of Common Pleas of

¹²⁶ See *infra* notes 140–155 and accompanying text.

¹²⁷ See *infra* notes 130–139 and accompanying text.

¹²⁸ See *infra* notes 140–155 and accompanying text.

¹²⁹ See *infra* notes 156–190 and accompanying text.

¹³⁰ See, e.g., *Borowski v. Fristar Bank*, 579 N.W.2d 247, 250 (Wis. Ct. App. 1998).

¹³¹ U.C.C. § 4-406(f) (2002) (providing that without regard to lack of care by either the customer or the bank, a customer who does not report fraudulent activity within a year after the statement is made available is barred from asserting against the bank an unauthorized signature or alteration).

¹³² See *id.*; see also JAMES J. WHITE & ROBERT S. SUMMERS, *UNIFORM COMMERCIAL CODE* 893 (6th ed. 2010) (stating that a short statute of limitations effectively disclaims liability).

¹³³ *Mercantile Bank of Ark. v. Vowell*, 117 S.W.3d 603, 612 (Ark. Ct. App. 2003); *Concrete Materials Corp. v. Bank of Danville & Trust Co.*, 938 S.W.2d 254, 257 (Ky. 1997).

¹³⁴ See *Mercantile Bank*, 117 S.W.3d at 612 (enforcing a thirty-day limit); *Concrete Materials*, 938 S.W.2d at 257 (suggesting that a sixty-day period is effective); *Borowski*, 579 N.W.2d at 252–53 (holding that altering the time to report fraudulent checks to fourteen days is not manifestly unreasonable and therefore is effective).

¹³⁵ *Crescent Women's Med. Grp., Inc. v. Keycorp.*, 806 N.E.2d 201, 205 (Ohio Ct. Com. Pl. 2003); see also *Am. Airlines Emps. Fed. Credit Union v. Martin*, 991 S.W.2d 887, 896 (Tex. App. 1999) (refusing to enforce a sixty-day limitation provision that was ambiguous and to which the customer did not knowingly consent).

Ohio refused to enforce contractual provisions that limited the notification period to fourteen days.¹³⁶ The court reasoned that the fraud was on the indorsement of the check and stated that the UCC provides no duty for the customer to inspect such indorsements.¹³⁷ Generally, courts have allowed a limitation of the notification period for banks' customers so long as the limitation is not manifestly unreasonable.¹³⁸ Although the limitation might become manifestly unreasonable at some point, so long as the bank does not seek to limit the period to less than fourteen days, courts in most jurisdictions uphold the limitations as enforceable.¹³⁹

B. *The Ability to Vary Section 4-401 via Facsimile Agreements*

The first movement by banks to avoid liability for paying checks that were not properly payable under section 4-401 involved facsimile agreements.¹⁴⁰ Facsimile agreements vary the standard rules by stating that any check that bears a facsimile signature, or what appears to be a facsimile signature, will be charged to the depositor whether or not it was authorized.¹⁴¹ Facsimile agreements called for the bank to pay any check presented to the bank that bore the company's facsimile signature, whether or not the check was actually authorized.¹⁴²

Perini Corp. v. First National Bank of Habersham County, a 1977 case from the U.S. Court of Appeals for the Fifth Circuit, was one of the first cases to examine facsimile agreements.¹⁴³ In *Perini*, someone gained

¹³⁶ *Crescent*, 806 N.E.2d at 205.

¹³⁷ *Id.*

¹³⁸ *Mercantile Bank*, 117 S.W.3d at 612; *Bank of Am., N.A. v. Putnal Seed & Grain, Inc.*, 965 So. 2d 300, 301 (Fla. Dist. Ct. App. 2007) (holding that a limitation of the time period in the deposit agreement to sixty days was enforceable); see also WHITE & SUMMERS, *supra* note 132, at 893 (supporting these clauses to the extent that they place the risk on the employer for embezzlement).

¹³⁹ See, e.g., *Mercantile Bank*, 117 S.W.3d at 612 (enforcing a thirty-day limit); *Putnal Seed & Grain*, 965 So. 2d at 301 (upholding a limitation to sixty days); *Stowell v. Cloquet Co-op Credit Union*, 557 N.W.2d 567, 571–72 (Minn. 1997) (enforcing a twenty-day contractual period); *Borowski*, 579 N.W.2d at 252–53 (upholding a fourteen-day limit); see also WHITE & SUMMERS, *supra* note 132, at 894 (stating that courts generally are willing to restrict a customer's time to give notice of errors).

¹⁴⁰ *Perini Corp. v. First Nat'l Bank of Habersham Cnty.*, 553 F.2d 398, 400 (5th Cir. 1977).

¹⁴¹ *Id.* A facsimile signature is a reproduction of a signature or symbol that authorizes payment. See *id.* In a facsimile agreement, check-writing equipment would produce a facsimile signature, and the company and the bank agreed that this signature would bind the company on the check. See *id.*

¹⁴² *Id.*

¹⁴³ *Id.*

access to corporate check-writing equipment and used it to print unauthorized checks.¹⁴⁴ The court held that the facsimile provision was enforceable and precluded the customer's claims that the checks bore unauthorized signatures, because the checks did in fact bear the facsimile signature.¹⁴⁵

This concept has been expanded over the years.¹⁴⁶ For example, the 1996 Louisiana Appeals Court case, *Jefferson Parish School Board v. First Commercial Corp.*, involved a similar facsimile agreement.¹⁴⁷ There, the court did not note how the checks were actually created.¹⁴⁸ The court enforced the agreement, stating that although diligent bank personnel may have been able to notice the checks' problems, the bank was entitled to enforce the agreement and thus was not liable to pay on the checks.¹⁴⁹ This decision has come under criticism from at least one commentator, who has noted that enforcing a clause like this shifts too much liability onto the users of the payment system.¹⁵⁰

There have also been decisions that have held that facsimile agreements were not enforceable.¹⁵¹ In the 1997 case, *Kaiser Aluminum & Chemical Corp. v. Mellon Bank*, the bank lacked any evidence that its customer was negligent or failed to use ordinary care in its handling of the check equipment.¹⁵² There, the U.S. District Court for the Western District of Pennsylvania stated that the facsimile clause was not enforceable because it did not attempt to limit or negotiate liability, but was rather a complete disclaimer of all liability, which was barred by section 4-103.¹⁵³

Similarly, in the 1981 case, *Cumis Insurance Society, Inc. v. Girard Bank*, the U.S. District Court for the Eastern District of Pennsylvania stated that because of its superior bargaining power, a bank, as a matter

¹⁴⁴ *Id.*

¹⁴⁵ *Id.* at 403.

¹⁴⁶ *Jefferson Parish Sch. Bd. v. First Commerce Corp.*, 669 So. 2d 1298, 1299 (La. Ct. App. 1996); see also WHITE & SUMMERS, *supra* note 132, at 902 (stating that they would endorse certain agreements that place the risk of a wrong signature on the depositor).

¹⁴⁷ *Jefferson Parish*, 669 So. 2d at 1300. The provision provided that the bank was entitled to honor and charge any checks that resembled the facsimile specimens. *Id.*

¹⁴⁸ See *id.* at 1301.

¹⁴⁹ *Id.*

¹⁵⁰ Rogers, *supra* note 25, at 485-86.

¹⁵¹ *Kaiser Aluminum & Chem. Corp. v. Mellon Bank, N.A.*, No. CIV.A 69-399, 1997 WL 361354, at *6 (W.D. Pa. June 24, 1997); *Cumis Ins. Soc'y, Inc. v. Girard Bank*, 522 F. Supp. 414, 422-23 (E.D. Pa. 1981).

¹⁵² 1997 WL 361354, at *2.

¹⁵³ *Id.* at *5.

of law, cannot contractually absolve itself of all liability.¹⁵⁴ The court went on to state that there is significant doubt as to the validity of an agreement that seeks to change the fundamental rules of liability set out in Article 4.¹⁵⁵

C. The Distinction Between Positive Pay and Facsimile Cases from Time Limitation Cases: Why Positive Payment and Facsimile Agreements Should Not Be Enforceable

Courts have, for the most part, enforced both facsimile agreements and time limitation provisions varying the default rules of Article 4.¹⁵⁶ The enforcement of facsimile agreements, like positive payment agreements, is problematic because it shifts liability from banks to their depositors.¹⁵⁷ This Section first identifies the differences between positive payment systems and time limitation provisions in deposit agreements, and then discusses how those differences result in differential treatment by courts.¹⁵⁸ This Section then explains the similarities and differences between positive payment and facsimile cases, and argues that despite their differences, neither should be enforceable.¹⁵⁹

1. The Difference Between Positive Payment and Time Limitation Provisions

Although courts have been aggressive in upholding time limitation provisions in deposit agreements that vary the default rules of section 4-406, courts should hesitate to take such an aggressive approach in cases in which the depositor's substantive rights in default provisions of the UCC are varied, such as with positive payment provisions.¹⁶⁰ In cases in which the deposit agreement contains a time limitation provision, the depositor's substantive rights are not altered; instead, the customer must simply notify the bank in a more timely fashion.¹⁶¹ These cases do

¹⁵⁴ 522 F. Supp. at 422–23.

¹⁵⁵ *Id.*

¹⁵⁶ See *infra* notes 160–168 and accompanying text.

¹⁵⁷ See *infra* notes 160–190 and accompanying text.

¹⁵⁸ See *infra* notes 160–168 and accompanying text.

¹⁵⁹ See *infra* notes 169–190 and accompanying text.

¹⁶⁰ See *Mercantile Bank*, 117 S.W.3d at 612; *Concrete Materials*, 938 S.W.2d at 257; *Borowski*, 579 N.W.2d at 251. The time limitation rules can vary significantly, from the standard year to as little as fifteen days. See *Mercantile Bank*, 117 S.W.3d at 612; *Borowski*, 579 N.W.2d at 251.

¹⁶¹ See U.C.C. § 4-406 (2002) (providing that the depositor has a year to notify the bank of unauthorized charges).

not raise issues about what the fundamental rights of the depositor are, but instead raise statute of limitations issues about how much time the depositor retains claims; the depositor still has all the rights stipulated by the UCC.¹⁶²

Although the time limitation provisions in deposit agreements may make it more difficult for businesses to take advantage of their rights, so long as they adhere to good business practices, they should have ample time to notify the bank of an unauthorized payment.¹⁶³ These provisions simply require that a business promptly and carefully inspect its statements in order to determine if there has been a fraudulent transaction.¹⁶⁴

Furthermore, there is a significant public policy benefit in limiting the notification period, because a shorter notification period allows banks to more easily protect against losses due to fraud.¹⁶⁵ Fraud losses often occur because a fraudster has gained access to a corporate account and continues to write checks over a period of months or even years.¹⁶⁶ Shortened notification times encourage quick reporting to the bank, which then can flag the account and look more carefully for potentially suspicious activity.¹⁶⁷ The reduction of fraud losses for banks benefits all depositors because banks must effectively insure against fraud losses projected each year, and in turn, charge higher fees or offer lower interest rates to depositors to offset fraud losses.¹⁶⁸

¹⁶² See *id.* §§ 4-401, 4-406.

¹⁶³ See *Borowski*, 579 N.W.2d at 251–53 (holding that a fourteen-day time notification limit was not manifestly unreasonable). In most cases, the business will have more than two weeks to respond to the unauthorized charge. See, e.g., *Mercantile Bank*, 117 S.W.3d at 612 (thirty days); *Concrete Materials*, 938 S.W.2d at 257 (sixty days).

¹⁶⁴ See *Mercantile Bank*, 117 S.W.3d at 612.

¹⁶⁵ See *Borowski*, 579 N.W.2d at 252 (describing the limiting of litigation as a valuable goal of a banking system in which there are millions of transactions every day).

¹⁶⁶ See U.C.C. § 4-406(d) (providing that a customer is precluded from asserting an unauthorized signature if the bank proves that it suffered a loss because of the customer's failure to inspect). Comment 2 of section 4-406 makes clear that the UCC's drafters were worried about the possibility of multiple frauds being perpetrated by the same person on the same account. See *id.* § 4-406 cmt 2.

¹⁶⁷ See U.C.C. § 4-406 cmt. 2 (2002).

¹⁶⁸ See *id.* (stating that the best way to protect against multiple fraud losses is for the customer to examine the statement promptly and notify the bank of an unauthorized signature).

2. The Distinction Between Positive Payment Agreements and Facsimile Signature Agreements

Although they both vary section 4-401's default rule by agreement, facsimile agreements do not have as harmful an effect as positive payment agreements because many of the cases they govern are those in which the UCC would otherwise preempt the depositor's right to bring a suit to recredit the account.¹⁶⁹ Facsimile provisions in depositor agreements provide that any item presented for payment to the bank bearing the facsimile signature or one resembling the facsimile signature will be paid by the bank.¹⁷⁰ The bank then has the power under the agreement to deduct the amount from the depositor's account even if an item was not technically authorized by the depositor.¹⁷¹

There are three types of transactions that these agreements could govern in which the item would not otherwise be authorized.¹⁷² In the first situation, an employee attains access to his or her company's facsimile and check-printing capabilities and writes checks that are not for the benefit of the company.¹⁷³ In the second situation, a fraudster gains access to the corporate check account because of some negligence on the part of the corporation; in the third, the fraudster does not gain access to the machine but instead receives a check, and, using modern technology, reproduces a similar-looking check bearing a signature either equivalent or nearly equivalent to the facsimile.¹⁷⁴

The first situation is not problematic because in a majority of such cases, the employer would be precluded from bringing an action against the bank to recredit its account due to provisions that hold the employer responsible if it is within the employee's job responsibilities

¹⁶⁹ See *id.* § 3-405 (providing that a forged signature is effective against an employer if the employer entrusted the employee with responsibility to that type of instrument); *id.* § 3-406 (providing that if a party is negligent and the negligence substantially contributes to a forged signature, the party is preempted from challenging the signature).

¹⁷⁰ See, e.g., *Perini*, 553 F.2d at 400. For example, in *Perini*, the exact provision at issue, called a corporate resolution, authorized the banks to "honor all checks . . . in the name of Perini Corporation on its Regular Accounts . . . when bearing or purporting to bear the single facsimile signature of R.A. Munroe. . . . Said banks shall be entitled to honor and charge Perini Corporation for all such checks." *Id.*

¹⁷¹ *Id.*

¹⁷² See U.C.C. § 4-401.

¹⁷³ *Perini*, 553 F.2d at 400; see *infra* notes 175–178 and accompanying text.

¹⁷⁴ Rogers, *supra* note 25, at 485–86; see *infra* notes 179–190 and accompanying text. For example, in *Jefferson Parish*, the court noted that the bank would not have been able to show negligence on the part of the other party. 669 So. 2d at 1299.

to make payments.¹⁷⁵ Article 3 provides multiple preemption rules, many of which focus on the employer setting and preclude an employer from suing the bank if the employer bears some responsibility for the fraudulent item.¹⁷⁶ If the employer had entrusted an employee with responsibility for that type of instrument, then that employee's fraudulent indorsement cannot be raised against a person who paid value for the instrument.¹⁷⁷ Therefore, if it was an employee who normally had access to the checkwriter in order to write payroll checks, then the company could not argue that the check was unauthorized because the bank took it for the purpose of collection.¹⁷⁸

The second situation involves a company's negligence with respect to proper protection of the company's facsimile machine and corporate checks; if a company is negligent, it would not be able to assert that the check was unauthorized.¹⁷⁹ This situation is broader than the entrusted employee scenario because there is no limitation on who perpetrated the fraud.¹⁸⁰ Here, the only necessary showing is that the corporation negligently supervised its corporate checking account.¹⁸¹ Article 3 provides that someone who substantially contributes to the making of a forged instrument is precluded from asserting the forgery against a party who has taken the instrument for collection.¹⁸² Therefore, if a company has been negligent in the supervision or protection of its corporate checking account, the bank would not be liable if there is an unauthorized signature.¹⁸³

The variation of section 4-401 posed by facsimile signatures is presented in the third scenario, in which the fraudster does not gain access to the corporate checking account due to negligence, but instead is able to replicate company checks with an accurate facsimile.¹⁸⁴ The UCC's default rule is clear in this situation: these are unauthorized items for which a bank cannot charge its depositor, and the bank must

¹⁷⁵ See U.C.C. §§ 3-405, 3-406 (2002); see also Rogers, *supra* note 25, at 490–91 (arguing that in an insider fraud case, the facsimile agreement is of negligible value because the company will be precluded from bringing the claim for repayment).

¹⁷⁶ U.C.C. §§ 3-405, 3-406.

¹⁷⁷ *Id.* § 3-405.

¹⁷⁸ See *id.*

¹⁷⁹ See *id.* § 3-406.

¹⁸⁰ See *id.*

¹⁸¹ See *id.*

¹⁸² U.C.C. § 3-406 (2002).

¹⁸³ *Id.*

¹⁸⁴ See *id.* §§ 3-405, 3-406. Neither section 3-405 nor section 3-406 would apply in this scenario, and thus the bank normally would be obligated to recredit the depositor's account in the amount of the item. See *id.* §§ 3-405, 3-406, 4-401.

bear the loss.¹⁸⁵ This is a situation in which the facsimile provision changes the default rule of the UCC and thus is essentially the same as the situation caused by positive payment waivers; unauthorized checks that are not the result of the company's negligence would be charged to the company's account.¹⁸⁶

This third scenario is ultimately the same as situations caused by positive payment, because positive payment provisions are designed to cover all unauthorized checks.¹⁸⁷ If section 4-401 can be altered through section 4-103 without disclaiming ordinary care, there is little left to the depositor-bank relationship because the bank does not have a complete obligation to repay for the benefit of the depositor.¹⁸⁸ Under pre-UCC common law, the duty for the bank was one of a creditor to its debtor, such that once the deposit was entered into the bank's books, the depositor was entitled to a creditor's right to repayment.¹⁸⁹ The repayment had to be made to the creditor, and not to another party, unless expressly designated and made on behalf of the creditor.¹⁹⁰

III. WHY VARIATION OF SECTION 4-401 SHOULD NOT BE ALLOWED AND HOW COURTS SHOULD HANDLE ARTICLE 4 VARIATION ISSUES

Banks should not be allowed to vary section 4-401 of the UCC by agreement with their depositors; banks' historical duty to their depositors is to repay debt as directed by the depositors, and varying this duty destroys any contractual duty the bank may have to its depositors.¹⁹¹ Section A of this Part describes theories that analyze the efficiency of varying section 4-401 and argues that not allowing variation is the most efficient.¹⁹² Section B discusses the common law duty of a depository bank to its customer and argues that allowing the bank to vary this duty results in a nonsensical paradigm.¹⁹³ Section C argues that section 4-103 was not originally intended to apply to section 4-401 and that it

¹⁸⁵ *Id.* §§ 3-405, 3-406.

¹⁸⁶ *See Jefferson Parish*, 669 So. 2d at 1299.

¹⁸⁷ *See Cincinnati Ins. Co. v. Wachovia Bank*, No. 08-CV-2734, 2010 WL 2777478, at *4 (D. Minn. July 14, 2010).

¹⁸⁸ *See Tex. Commerce Bank-Hurst v. United States*, 703 F. Supp. 592, 594 (N.D. Tex. 1988); *Mallett v. Tunncliffe*, 136 So. 346, 348 (Fla. 1931); *Caledonia Nat'l Bank of Danville v. McPherson*, 75 A.2d 685, 687 (Vt. 1950).

¹⁸⁹ *Tex. Commerce*, 703 F. Supp. 592 at 594; *Mallett*, 136 So. at 348; *Caledonia*, 75 A.2d at 687.

¹⁹⁰ *See Tex. Commerce*, 703 F. Supp. at 594; *Mallett*, 136 So. at 348.

¹⁹¹ *See infra* notes 196–346 and accompanying text.

¹⁹² *See infra* notes 196–272 and accompanying text.

¹⁹³ *See infra* notes 273–301 and accompanying text.

should not currently.¹⁹⁴ Finally, Section D proposes a solution for courts to retain the meaning of section 4-103 for the duties of banks in collection while still not allowing banks to vary their traditional duties to depositors embodied in section 4-401.¹⁹⁵

A. Theories Relating to Risk Allocation in the Check System and Why Strict Liability or No Variation of Section 4-401 Is Economically Efficient

Theories relating to check loss, payment systems, and commercial transactions aid the development of commercial law by helping it provide a beneficial system for the transactions it regulates.¹⁹⁶ First, this Section discusses the theories of finality and banks as payment system providers, as support for why banks should not be able to vary the standard risk allocation.¹⁹⁷ Second, this Section explains how freedom of contract theory supports banks' ability to negotiate who bears the risk of loss.¹⁹⁸ Third, this Section argues that it is economically efficient to stipulate in Article 4 that section 4-401 may not be varied.¹⁹⁹

1. Theories Supporting No Variation: Finality and the Idea That Banks Should Bear the Risk of Loss as the Payment System Provider

If section 4-401 and the risk allocation provisions in Article 4 cannot be varied, then the Code provides for stable rules and expectations on which businesses can depend.²⁰⁰ Finality is the idea that once a transaction has occurred, there should be minimal debate over it, and thus minimal litigation.²⁰¹ Finality promotes easy allocation of the loss without litigation, thereby realizing a main policy goal of the UCC: minimizing litigation.²⁰² The finality rule draws support from Article 3, which governs negotiable instruments, because people who paid value and took the item in good faith are entitled to payment.²⁰³

¹⁹⁴ See *infra* notes 302–326 and accompanying text.

¹⁹⁵ See *infra* notes 326–346 and accompanying text.

¹⁹⁶ See *infra* notes 196–272 and accompanying text.

¹⁹⁷ See *infra* notes 200–234 and accompanying text.

¹⁹⁸ See *infra* notes 235–253 and accompanying text.

¹⁹⁹ See *infra* notes 254–272 and accompanying text.

²⁰⁰ Overby, *supra* note 118, at 361 n.63.

²⁰¹ *Id.* at 361.

²⁰² U.C.C. § 1-103(a)(1) (2002) (stating that the goal of the UCC is clarity and simplicity).

²⁰³ See *id.* § 3-418. Section 3-418(c) provides that there are no remedies against a person who took an instrument in good faith and for value or who changed his or her position in reliance on the payment. *Id.* § 3-418(c). In this case, the drawee will not have an

Finality in payment encourages commercial transactions and can provide stability to the commercial system.²⁰⁴ Finality was a traditional justification for drawee liability, and it promotes a positive business environment by allowing businesses to close transactions quickly and efficiently.²⁰⁵ The first edition of the Restatement of Restitution expressly supported this view and stated that a rule of finality in negotiable instruments would allow “mercantile instruments in situations where ordinarily it is reasonably possible for the payor to ascertain the fraud.”²⁰⁶

For finality to operate properly, liability must be placed squarely on one party or another party in a quasi-strict liability scheme in order to minimize litigation.²⁰⁷ Some commentators have argued that banks should bear the risk of loss because, as the payment system providers, there are significant policy incentives for them to do so.²⁰⁸ Placing the risk of loss on banks provides a strong incentive for the banks to develop new technologies and procedures to minimize potentially avoidable losses that occur due to check fraud.²⁰⁹ Across different payment systems, the law is relatively uniform in that the risks of unavoidable losses (losses that are not due to negligence of any party) from unauthorized payments are borne by the provider and that these provisions cannot be varied by agreement of the parties.²¹⁰

Placing liability on banks for the unavoidable losses from fraud conforms to all of the other modern payment systems.²¹¹ The main principle of modern payment systems is that payment system providers—generally the banks or financial institutions that provide for the processing of the payment—bear the cost of the unavoidable loss due to fraud.²¹² The providers then spread the risk across the system, through customer or merchant fees, in order to insure against extensive losses due to fraud.²¹³ For example, the regulations for the credit

action against the person paid because there usually is a person who took the check in good faith and for value. *See id.*

²⁰⁴ RESTATEMENT (FIRST) OF RESTITUTION § 30 cmt. a (1937).

²⁰⁵ *See id.*

²⁰⁶ *Id.*

²⁰⁷ Overby, *supra* note 118, at 361 n.63.

²⁰⁸ Robert D. Cooter & Edward L. Rubin, *A Theory of Loss Allocation for Consumer Payments*, 66 TEX. L. REV. 63, 106 (1987) (noting the innovation element of loss reduction if a financial institution is subject to liability); Rogers, *supra* note 25, at 463–67 (arguing that banks should bear the risk of unavoidable loss due to check fraud).

²⁰⁹ Cooter & Rubin, *supra* note 208, at 106; Overby, *supra* note 118, at 361.

²¹⁰ Rogers, *supra* note 25, at 454.

²¹¹ *See id.*

²¹² *Id.*

²¹³ *Id.*

card system, which address the relationships between the user, issuer, merchant, and network, provide that so long as the user notifies the issuing bank (the system provider) in an adequate amount of time, the user's maximum liability for unauthorized fraudulent charges is only fifty dollars.²¹⁴

Similarly, the debit card system, which governs the procedures and liabilities between the parties involved in processing debit card payments, provides a maximum liability scheme with the lowest ceiling of \$50 escalating to \$500 or more depending on the timeliness of the customer's response.²¹⁵ In the debit card system, if the customer does not report the unauthorized transfer within sixty days, the bank does not have to reimburse losses that would not have occurred if the customer gave timely notice.²¹⁶ As in the credit card system, in the debit card system if the customer reports in a timely manner, the customer's liability is capped at fifty dollars.²¹⁷ This is the only manner in which a customer may be held liable for unauthorized charges on its account.²¹⁸ Consumer electronic funds transfers are also governed by these rules.²¹⁹

Even the wire transfer system, which governs the rights and obligations of both customers and fulfilling banks, and is designed primarily for business-to-business transactions, has rules designed to allocate the risk of unavoidable loss to the system provider.²²⁰ Banks bear the risk of loss unless the customer is at fault.²²¹ If a payment order—an order directing a bank to make payment—was not authorized by the customer, the bank is not entitled to enforce the order unless the customer made an external mistake.²²² The bank can hold the customer liable for the payment order only if the bank and the customer have agreed to a reasonable security procedure and the bank follows the security procedure

²¹⁴ Truth in Lending Act, Pub. L. No. 90-321, 82 Stat. 146 (codified as amended at 15 U.S.C. § 1643 (2006)).

²¹⁵ Electronic Funds Transfer Act (EFTA), 15 U.S.C. § 1693g(a)(1) (2006) (stating that a consumer's liability for an unauthorized transfer exceeds the lesser of fifty dollars or the amount of money obtained in such unauthorized fund transfers prior to notification).

²¹⁶ *Id.*; see Liability of Consumer for Unauthorized Transfers, 12 C.F.R. § 205.6 (2012).

²¹⁷ 12 C.F.R. § 205.6 (providing that if the consumer notifies the bank within two business days after learning of the loss or the theft of an access device, then the customer's liability will not exceed fifty dollars).

²¹⁸ 15 U.S.C. § 1693g(c).

²¹⁹ *Id.* § 1693g(a). EFTA and Regulation E, promulgated pursuant to EFTA, govern consumer electronic funds transfers, of which debit cards are included. 12 C.F.R. § 205.3(b).

²²⁰ U.C.C. § 4A-201 to -203 (2002).

²²¹ *Id.* § 4A-203.

²²² *Id.* The receiving bank can only enforce the order if the order was made by a person entrusted with a duty for security procedures or payment orders or who obtained access to the customer's transmission from a source controlled by the customer. *Id.*

in making the order.²²³ These rules are stipulated even though fraud loss presents a massive problem for the wire transfer system because, unlike other payment systems, wire transfers handle uniquely large amounts of money per order.²²⁴ In fact, due to their reliability and fast finality, wire transfers account for about eighty-five percent of all money passing through payment systems.²²⁵

Article 4A of the UCC, governing wire transfers, ultimately provides that the rules governing the risk of loss cannot be varied by agreement.²²⁶ Section 4A-202, which governs the liability of customers on their transfer orders, allows only a minimal amount of variation, stating that the provision can be varied only to the extent provided for in section 4A-203(a)(1).²²⁷ Section 4A-202(b) provides that a bank and customer can agree on a certain security procedure.²²⁸ Section 4A-203(a)(1) provides that a receiving bank can limit the extent to which it is entitled to enforce or retain payment of the payment order by written agreement with the customer.²²⁹ These rules effectively put the emphasis on security and encourage all parties to maintain their security procedures in order to reduce fraud loss in the system.²³⁰

There is a strong argument that if payment systems have to bear the risk of unavoidable losses, then the system providers will be incentivized to develop new technology and procedures to minimize the risk.²³¹ The median cost of fraud prevention services for money center banks in 2004 was between \$5 and \$20 million, not counting the cost of losses from fraudulent checks.²³² Banks spend a substantial amount of money in an attempt to protect the system against losses.²³³ Therefore, there is a strong argument that placing the liability for unavoidable losses on banks has produced an effort by the banks to step up the prevention of fraud, theoretically decreasing costs for everyone through lower customer fees and fewer fraudulent losses.²³⁴

²²³ *Id.* § 4A-202.

²²⁴ *Id.* § 4A prefatory note (stating that the dollar value of payments made by wire transfers far exceeds any other payment method).

²²⁵ Rogers, *supra* note 25, at 476–77.

²²⁶ U.C.C. § 4A-202(f) (2002).

²²⁷ *Id.*

²²⁸ *Id.* § 4A-202(b).

²²⁹ *Id.* § 4A-203(a)(1).

²³⁰ *See id.*

²³¹ Overby, *supra* note 118, at 361.

²³² *See* Grengs & Adams, *supra* note 118, at 184 n.161.

²³³ *See id.*

²³⁴ *See id.*

2. Freedom of Contract: A Theory Supporting Varying Section 4-401 by Agreement

Freedom of contract principles support the ability of customers and their banks to vary the provisions of the UCC in order to allocate risk between the parties as they choose.²³⁵ Commentators argue that allowing parties to allocate the risk of loss as they choose will lead to the burden of the loss falling on the party that can most adequately bear it.²³⁶

This theory is analogous to Judge Learned Hand's theory outlined in the 1947 case before the U.S. Court of Appeals for the Second Circuit, *United States v. Carroll Towing Co.*²³⁷ The case involved the question of who should bear the loss in the crash and sinking of a towboat due to negligence by the defendant.²³⁸ Judge Hand reasoned that whether a duty existed for the defendant to prevent the plaintiff's loss could be determined by an equation that included: (1) the probability (P) that the boat will break away; (2) the seriousness of the possible loss (L) if it did break away; and (3) the burden (B) of adequate protections, shown in the formula $B < PL$.²³⁹ Liability is incurred by a potentially negligent defendant when the probability of the harm occurring multiplied by the cost of the harm is greater than the burden of the adequate protection.²⁴⁰ According to this formula, if the burden of the protection is greater than the calculated potential harm, then the defendant either has no duty or has satisfied the duty of care and the victim must bear the cost of damage.²⁴¹ This calculation is merely another way to determine the party who can most efficiently prevent and insure against the risk of loss.²⁴²

With Judge Hand's theory in mind, theories have since been developed to allocate risk in the most efficient ways in other areas of the law, not traditionally thought to have economic policy rationales.²⁴³ For example, one theory suggests that, for business accounts in the check

²³⁵ *Id.* at 164.

²³⁶ *Id.*

²³⁷ 159 F.2d 169, 173 (2d Cir. 1947).

²³⁸ *Id.* at 170.

²³⁹ *Id.* at 173.

²⁴⁰ *Id.*

²⁴¹ *See id.*

²⁴² *See id.*; RICHARD A. POSNER, *ECONOMIC ANALYSIS OF LAW* 167 (7th ed. 2007).

²⁴³ *See, e.g.*, POSNER, *supra* note 242, at 167; Guido Calabresi, *Some Thoughts on Risk Distribution and the Law of Torts*, 70 YALE L.J. 499, 503 (1961); Adam Candeub, *An Economic Theory of Criminal Excuse*, 50 B.C. L. REV. 87, 90–91 (2009) (applying Judge Hand's theory to the availability of criminal excuses).

system, it might be more efficient for the customer to bear at least some of the risk of loss for fraudulent checks.²⁴⁴

Professor Ronald Coase's famous theory of social costs is relevant to the issue of whether it would be efficient to allow banks and their customers to vary the risk allocation scheme.²⁴⁵ Professor Coase has argued that whether or not liability is structured by the law, the costs to society will be the same.²⁴⁶ He uses the example of a farmer and a herder to demonstrate that, in a perfect market, the market will price in the liability in order to reach the same result.²⁴⁷ He ultimately argues that legal and economic commentators, when looking to social policy, should use an opportunity cost analysis to determine the social benefits and costs of different structures, much like economists apply in the firm context.²⁴⁸

Professor Coase's theory and analysis can be used to demonstrate that a strict allocation of risk among the banks provided for in Article 4 is not efficient because costs to the banks within this structure are greater than the corresponding social costs.²⁴⁹ It is only efficient for the payor bank to work to reduce fraud to the extent that the costs of combating fraud are lower than the costs of the fraud itself.²⁵⁰ Furthermore, it is even more inefficient because banks are forced to work on fraud prevention, something for which they are neither well suited nor efficient.²⁵¹

Others have argued that banks are inefficient at detecting fraud, and thus the social costs are actually higher because the banks as system providers spread the artificially high costs of the system, due to the attempts to prevent fraud, across the entire user base.²⁵² Allowing banks to vary the provisions of section 4-401 could lead to lower transaction costs for banks and a more efficient system.²⁵³

²⁴⁴ Calabresi, *supra* note 243, at 551; *see also* POSNER, *supra* note 242, at 11 (defining efficiency as the allocation of resources in which value is maximized).

²⁴⁵ Grengs & Adams, *supra* note 118, at 188–89; *see* R.H. Coase, *The Problem of Social Cost*, 3 J.L. & ECON. 1, 7–8 (1960).

²⁴⁶ Coase, *supra* note 245, at 7–8.

²⁴⁷ *Id.*

²⁴⁸ *Id.* at 43.

²⁴⁹ Grengs & Adams, *supra* note 118, at 186–87; *see* POSNER, *supra* note 242, at 11; Coase, *supra* note 245, at 2.

²⁵⁰ *See* Grengs & Adams, *supra* note 118, at 189.

²⁵¹ *Id.* at 191.

²⁵² *See id.* at 193; *see also* POSNER, *supra* note 242, at 6 (defining social cost as a cost that diminishes the wealth of society).

²⁵³ Grengs & Adams, *supra* note 118, at 201.

3. A Theoretical Argument Supporting a Standard Risk Allocation Scheme

A strict liability regime for banks bearing unavoidable fraud losses from paying unauthorized checks provides for finality within the system and allows for parties to move on quickly following the challenge of an unauthorized check.²⁵⁴ A standard rule would minimize litigation because there would not be questions as to whether provisions such as facsimile or conditioned positive payment are enforceable as variations of section 4-401.²⁵⁵ Furthermore, finality allows both sides to depend on standard rules, and thus provides adequate protection in case something goes wrong.²⁵⁶ Without clarity, it is possible that one party could be underinsured, or alternatively that both parties would insure against the loss, resulting in an over-insured society and an inefficient allocation of resources.²⁵⁷ Between the clarity and finality of the strict liability rule, the result of the nonvariability will be increased efficiency within the banking system and the greater economy.²⁵⁸ This is because resources are allocated such that value is maximized.²⁵⁹

Strict liability would benefit the check system because after the check is paid by the payor bank, the account holder no longer can challenge the result of the transaction.²⁶⁰ The payor's bank has at least some measure of control over determining whether the item is actually authorized.²⁶¹ This is similar to a contractual situation in which the promisor is in a better position to stop the harm, making strict liability appropriate.²⁶² Holding banks strictly liable encourages them to develop new technologies to detect check fraud, such as, for example, by using electronic presentment with applicable images of the checks along with a technology that could detect alterations.²⁶³

²⁵⁴ See Overby, *supra* note 118, at 361 n.63.

²⁵⁵ See U.C.C. § 4-401 (2002); POSNER, *supra* note 242, at 180 (providing that strict liability in tort makes litigation simpler and thus leads to lower litigation costs).

²⁵⁶ Overby, *supra* note 118, at 361 & n.63; see POSNER, *supra* note 242, at 185.

²⁵⁷ See POSNER, *supra* note 242, at 185 (providing that uncertainty prevents firms from determining how much they should invest to prevent accidents).

²⁵⁸ See *id.* at 11.

²⁵⁹ *Id.*

²⁶⁰ See *id.* at 182 (stating that strict liability is appropriate in contractual situations because the promisor is in a better position to stop the harm).

²⁶¹ See ROGERS, *supra* note 11, at 140 (noting that this is true even though only a small percentage of the items are manually inspected).

²⁶² See POSNER, *supra* note 242, at 182.

²⁶³ See Cooter & Rubin, *supra* note 208, at 106; Overby, *supra* note 118, at 361.

Strict liability could also limit the number of claims leading to litigation, thereby decreasing costs throughout the system, because claims would be easier to settle with a clear rule.²⁶⁴ Even the claims that do not reach litigation would proceed with fewer contested issues because strict liability would have eliminated some claims, thereby limiting the average cost per case.²⁶⁵ This combination of efficiencies should lower overall litigation costs and provide an economic gain.²⁶⁶ It would also permit the most efficient allocation of resources throughout society.²⁶⁷

It has been argued that strict liability would be too harsh on banks because they lack the resources necessary to inspect every check manually.²⁶⁸ This argument, however, beckons the answer.²⁶⁹ Banks have made the economic and fiscal choice not to inspect all items manually, unless they are above a certain dollar amount, because it is less expensive for them to later recredit accounts for fraudulent items.²⁷⁰ Presumably, banks could reduce fraud by manually inspecting every item, but this would result in increased employment costs to save on fraud expenses.²⁷¹ Therefore, the argument is a red herring as banks have historically been held strictly liable for the payment of fraudulent items, and thus the benefits of a form of strict liability outweigh the dangers of the costs placed on depositary banks.²⁷²

B. *The Payor Bank and Its Customer: Why Allowing Variation of Section 4-401 Disclaims the Bank's Historical Duties to Its Customer*

The common law duty of a depositary bank to repay its creditor informs how courts should interpret depositary provisions, which attempt to limit the depositary bank's liability for unauthorized checks.²⁷³ This Section first argues that the common law duty of banks must be included in an analysis of the variability of section 4-401 and discusses how that duty affects the analysis.²⁷⁴ This Section then argues that

²⁶⁴ See POSNER, *supra* note 242, at 180.

²⁶⁵ See *id.*

²⁶⁶ See *id.*

²⁶⁷ See *id.*

²⁶⁸ See Grengs & Adams, *supra* note 118, at 200.

²⁶⁹ See ROGERS, *supra* note 11, at 140 (noting that it is rare for banks to inspect items manually in the modern banking system).

²⁷⁰ See *id.*

²⁷¹ See *id.*; see also POSNER, *supra* note 242, at 167 (stating that businesses will deter the risk of loss only to the extent that it makes fiscal sense).

²⁷² See POSNER, *supra* note 242, at 167; ROGERS, *supra* note 11, at 140.

²⁷³ See *infra* notes 274–301 and accompanying text.

²⁷⁴ See *infra* notes 277–292 and accompanying text.

courts have ignored banks' common law duty and have thereby been led off track by both the technical language of section 4-401 and the perspective that the bank always wins.²⁷⁵ Finally, this Section discusses how courts' neglect of the common law duties of banks has increased banks' ability to vary their duties by agreement.²⁷⁶

1. The Common Law Duty of Banks and How It Affects the Analysis of the Variability of Section 4-401

The historical relationship between a bank and its depositor is clear: the money deposited into a bank became the property of the bank and the depositor became a creditor of the bank.²⁷⁷ The pre-UCC law was that a bank could charge a customer's account only for an authorized order by the account holder, which set off the bank's debt to the customer by the amount of the order.²⁷⁸

A bank's duties are fundamentally those of a debtor, and thus it is within the creditor-debtor setting that the phrase "lack of ordinary care" must be analyzed.²⁷⁹ The bank has the duty to repay the debt on demand.²⁸⁰ Demand is made through instruments that are authorized by the account holder.²⁸¹ In this situation, it does not make sense in the abstract for the bank to be able to charge an item to an account without authorization.²⁸² A bank deducting money from a customer's account for an unauthorized charge is analogous to a debtor missing a payment to a creditor.²⁸³ In the standard case of missing a payment to a creditor, the creditor will seek to enforce its contractual right to pay-

²⁷⁵ See *infra* notes 293–301 and accompanying text.

²⁷⁶ See *infra* notes 293–301 and accompanying text.

²⁷⁷ *Tex. Commerce Bank-Hurst v. United States*, 703 F. Supp. 592, 594 (N.D. Tex. 1988); *Mallett v. Tunncliffe*, 136 So. 346, 348 (Fla. 1931); *Caledonia Nat'l Bank of Danville v. McPherson*, 75 A.2d 685, 687 (Vt. 1950).

²⁷⁸ See *Tex. Commerce*, 703 F. Supp. at 594; *Mallett*, 136 So. at 349.

²⁷⁹ See *Tex. Commerce*, 703 F. Supp. at 594; *Mallett*, 136 So. at 349.

²⁸⁰ *Caledonia*, 75 A.2d at 688; see *Tex. Commerce*, 703 F. Supp. at 594; *Mallett*, 136 So. at 349.

²⁸¹ See U.C.C. § 3-108(a) (2002) (stating that a promise or order is payable on demand if it indicates that it is payable at the will of the holder).

²⁸² See *id.* Another way to think about the scenario is as if the bank had given the depositor a note for the amount deposited, that is payable on demand. See *id.* In that scenario, there would be no question that a payment made to some other unrelated third party would not count against the debt on the note. See *id.* §§ 3-108, 3-602 (providing that an instrument is paid to the extent payment is made to a person entitled to enforce the instrument).

²⁸³ See *id.* § 4-401 (stating that accounts can only be charged for items that are properly payable); *id.* § 3-602.

ment, often governed by a promissory note.²⁸⁴ The equivalent right in a depositor-bank relationship is for the depositor to bring a claim of breach of the bank's duty under section 4-401.²⁸⁵

An example of this scenario may be helpful: if Jim mails a check for his mortgage but the mailman steals the check and cashes it, Jim has no right to a reduction of his debt to the mortgage company, even though a check written to the company was paid out of his account.²⁸⁶ The mortgagee remains his creditor in the amount of Jim's most recent bill.²⁸⁷ This outcome is consistent with people's general intuition: the company did not receive any payment, so why should Jim be entitled to a reduction of his debt?²⁸⁸ Jim, in the typical case, would have an action against his bank for paying over a fraudulent indorsement, but this does not change the fundamental relationship between Jim and his creditor.²⁸⁹ Against his bank, Jim has a right to repayment because the payment was not made to the authorized party, and, therefore, as an unauthorized payment, Jim's bank does not have the right to deduct the amount from its debt to Jim.²⁹⁰ This hypothetical reinforces the idea that the positive payment concept embodied in section 4-401 should not be varied by agreement.²⁹¹ If a bank can deduct a charge from a depositor's account only if it is authorized, then Article 4 remains analogous to the regulation of the creditor-debtor relationship because only a payment that is received by a creditor is to its benefit and only an authorized charge is to the benefit of the customer.²⁹²

2. The Development of the Law Toward Variability and Why It Is Mistaken

Courts, however, have not given the creditor-debtor concept much weight when deciding both facsimile and positive payment cases.²⁹³ In-

²⁸⁴ See *id.* § 3-401 (stating that a person is not liable on the instrument unless he or she signed it).

²⁸⁵ See *id.* § 4-401.

²⁸⁶ See *id.* § 3-602(a).

²⁸⁷ See U.C.C. § 3-602(a) (2002).

²⁸⁸ See *id.*

²⁸⁹ See *id.* § 4-401 cmt. 1 (stating that an item is properly payable if the customer has authorized the payment); *id.* § 3-602(a).

²⁹⁰ See *id.* § 4-401.

²⁹¹ See *id.*

²⁹² *Tex. Commerce*, 703 F. Supp. at 594; *Mallett*, 136 So. at 349; U.C.C. § 4-401.

²⁹³ See *Cincinnati Ins. Co. v. Wachovia Bank*, No. 08-CV-2734, 2010 WL 2777478, at *6 (D. Minn. July 14, 2010) (discussing ordinary care only in reference to whether the bank used ordinary care in inspecting the check); *Jefferson Parish Sch. Bd. v. First Commerce Corp.*, 669 So. 2d 1298, 1299 (La. Ct. App. 1996).

stead, courts have looked at the provisions within the deposit agreement and have sought to hold them enforceable without considering the potential legal issues that they raise.²⁹⁴ This lack of consideration is perplexing given the language of section 4-103, which states that a bank cannot disclaim ordinary care.²⁹⁵

One potential reason why courts have been generally predisposed to uphold and impose facsimile provisions is because attorneys and judges have a mistaken belief that the general principle of the check system is that banks always win.²⁹⁶ Therefore, when the court sees a facsimile agreement, it is likely to uphold it both as a matter of contract law and due to the general understanding that, absent some other factor, the bank prevails under the UCC.²⁹⁷ There is some evidence to support this argument, as some literature has discussed the power of a bank and suggested that the bank is likely to win vis-à-vis its depositor.²⁹⁸

This reasoning explains courts' behavior regarding facsimile agreements.²⁹⁹ If attorneys and judges believe that the bank always wins in the standard case, then a facsimile agreement or a conditioned positive payment system does not seem unreasonable because it merely reinforces the normal outcome: that the bank always wins.³⁰⁰ Instead, it seems like banks have attorneys who are representing them well and minimizing legal costs.³⁰¹

C. *Why the Bank Does Not Always Win: Section 4-103 Was Never Meant to Apply to Section 4-401*

Unfortunately for the development of the law, the theory that the bank always prevails is incorrect.³⁰² The standard in the UCC is not that

²⁹⁴ *Cincinnati*, 2010 WL 2777478, at *6; *Jefferson Parish*, 669 So. 2d at 1299.

²⁹⁵ See U.C.C. § 4-103(a) (2002).

²⁹⁶ ROGERS, *supra* note 11, 134–35.

²⁹⁷ See *id.* at 135.

²⁹⁸ See, e.g., Beutel, *supra* note 60, at 359 (stating that proposed Article 4 was too bank friendly and was in fact a piece of class legislation); Gilmore, *supra* note 60, at 377 (agreeing with Professor Frederick Beutel that Article 4 should not have been passed as-is). Most of Professor Beutel's and Professor Grant Gilmore's criticism, however, revolves around how much power and latitude banks have in the collection of checks. See Beutel, *supra* note 60, at 360; Gilmore, *supra* note 60, at 377.

²⁹⁹ See *Cincinnati*, 2010 WL 2777478, at *6; *Jefferson Parish*, 669 So. 2d at 1299.

³⁰⁰ See ROGERS, *supra* note 11, at 135.

³⁰¹ See *id.* at 111 (explaining that many attorneys misinterpret the UCC's standard rule).

³⁰² See U.C.C. § 4-401 (2002). Only items that are properly payable can be charged to a depositor's account. *Id.* The comments to section 4-401 make clear that only an authorized payment is properly payable. *Id.* § 4-401 cmt. 1.

the bank always wins, but rather that the bank always loses unless it can show some type of negligence on the part of the drawer.³⁰³ This rule makes inherent sense in the context of a creditor-debtor relationship because, in the case of unavoidable loss (e.g., the scenario discussed above in which the mailman steals the check), the creditor has not received the benefit of the payment.³⁰⁴ Without the benefit of receiving payment, there would be no reason to become a creditor in the first place.³⁰⁵ Thus, absent a showing of negligence, the bank will and should always lose because the depositor, as a creditor, should receive a benefit when an amount is deducted from the account.³⁰⁶

The critical question becomes why Article 4 stipulates that its provisions can be varied so long as the bank does not disclaim its duty of ordinary care if a depositor, as a creditor of the bank, should always get a benefit when the bank repays some of the debt.³⁰⁷ The answer may be that the UCC's drafters assumed that the legal community would understand the background of creditor-debtor law, or, more likely, it may be a historical anachronism such that the rules governing the collection of items were included in the same Article as a bank's duties to its depositors.³⁰⁸ Article 4 originated from the ABA Code governing a bank's duties in the collection of the payment of checks.³⁰⁹ The provisions that govern a bank's duties to its depositors (Article 4, part 4) are derived from a common law line of cases that preceded the UCC, which stated that banks paid off the debt to their depositors by following the orders and directions of their depositors, and thus, perhaps the drafters of Article 4 believed that courts would defer to this tradition.³¹⁰

If the drafters wrote the UCC with the intention of courts and practitioners reading it within the context of the creditor-debtor nature of the depositor-bank relationship, then the main question becomes

³⁰³ See *id.* §§ 3-405, 3-406, 4-401.

³⁰⁴ See *Tex. Commerce*, 703 F. Supp. at 594 (stating that the depositor, as a creditor of the bank, has a right to direct the bank's disbursement of funds); *supra* notes 289–295 and accompanying text.

³⁰⁵ See *id.*

³⁰⁶ See *id.*

³⁰⁷ U.C.C. § 4-103.

³⁰⁸ ROGERS, *supra* note 11, 143–44; see also Beutel, *supra* note 60, at 359 (arguing that the bank collection provisions of Article 4 give banks too much power); Gilmore, *supra* note 60, at 376–77 (arguing that Article 4 should not have been adopted if section 4-103 were not adjusted because banks could abdicate liability in check collections).

³⁰⁹ ROGERS, *supra* note 11, at 143; Norwood, *supra* note 50, at 361; *supra* notes 58–61 and accompanying text.

³¹⁰ See *Mallett*, 136 So. at 348; *Caledonia*, 75 A.2d at 687; *Cross v. Amoretti*, 9 P.2d 147, 148 (Wyo. 1932).

what a bank's duty of ordinary care should be to its depositors.³¹¹ Under section 4-401, a bank can only charge a depositor's account for items that are properly payable.³¹² Both facsimile agreements and conditioned positive payment agreements allow a bank to change this standard to any item that is presented to the bank for payment, drawn on the customer's account.³¹³ If the standard of ordinary care does not ensure that the payments are actually at the direction of the creditor, then what is ordinary care?³¹⁴ As discussed below, this question becomes a bit of a logical quandary: if a debtor's duty is to pay its creditor, but it is allowed to vary this duty by agreement, what duty actually remains for the debtor to provide with ordinary care?³¹⁵ In such a scenario, there seems little left to the relationship that could not be disclaimed.³¹⁶

The logical conclusion, from the idea that a bank as a debtor to its depositor can deduct an amount from its debt for an item that was not authorized by the account holder, is that a bank is allowed to disclaim its most important duty to its depositor, the duty to repay.³¹⁷ Theoretically, if the bank does not have a strict duty to repay its depositors, there is little to a contractual obligation on the part of the bank at all.³¹⁸ Banks could accept depositors' money and grant them a creditor's right with an exception to the depositors' right to repayment for mistakes made by the bank regarding authorization.³¹⁹ If a payment was not authorized, then the payment does not benefit the creditor.³²⁰ This exception to repayment ultimately means that a bank has no obligation because the bank no longer must perform its singular duty to repay the debt to the creditor's benefit.³²¹

The problem becomes particularly pronounced when one considers that banks in the ordinary course of business do not examine items

³¹¹ See U.C.C. § 4-103(a) (2002).

³¹² *Id.* § 4-401.

³¹³ *Cincinnati*, 2010 WL 2777478, at *6; *Jefferson Parish*, 669 So. 2d at 1299.

³¹⁴ See U.C.C. § 4-103.

³¹⁵ See *Cincinnati*, 2010 WL 2777478, at *6; *Jefferson Parish*, 669 So. 2d at 1299; U.C.C. § 4-103.

³¹⁶ See *Cincinnati*, 2010 WL 2777478, at *6; *Jefferson Parish*, 669 So. 2d at 1299; U.C.C. § 4-103.

³¹⁷ See *Mallett*, 136 So. at 348; *Caledonia*, 75 A.2d at 687; *Cross*, 9 P.2d at 148.

³¹⁸ See *Tex. Commerce*, 703 F. Supp. at 594.

³¹⁹ See *Cincinnati*, 2010 WL 2777478, at *6; *Tex. Commerce*, 703 F. Supp. at 594; *Jefferson Parish*, 669 So. 2d at 1299.

³²⁰ See *Cross*, 9 P.2d at 148; U.C.C. § 4-401 (2002).

³²¹ See *Tex. Commerce*, 703 F. Supp. at 594.

that are presented for payment.³²² Depending on a particular bank's policy, there is usually a numerical value above which checks are manually inspected—for example, above \$5000—and banks also generally hand inspect a certain percentage of all other items presented for payment.³²³ But the vast majority of items presented for payment are never examined by a bank employee.³²⁴ Instead, a bank's computer processing system reads the check and deducts the applicable amount of money from the account number indicated.³²⁵ In this context, it is easy to see how difficult it is to prevent fraudulent checks from being paid and then deducted from the depositor's account.³²⁶

D. The Solution: Courts Must Remember That Banks Have a Common Law Duty to Repay Their Depositors as Creditors

The solution, therefore, is for courts to remember in these cases that banks are not governed only by the provisions of Article 4, but also by the common law, which imparts duties to a bank the moment a depositor hands over a payment device to a teller or an automated system.³²⁷ When presented with situations involving positive payment or facsimile agreements, courts should recognize that a bank's duties in the collection process are separate and distinct from its duties to its customers as depositors.³²⁸ In check collection, a bank's duty of ordinary care is to pursue a reasonable method to transfer the check for ultimate presentment to the payor bank.³²⁹ In comparison, a bank's duty to its customer is ultimately to repay the deposit when the customer demands.³³⁰

Courts should consider the sections of Article 4 that govern the bank's relationship with its customer according to a separate standard, taking into account that the main duty of a bank is to repay on demand the debt it owes to the depositor.³³¹ Analyzing part 4 of Article 4, which governs the relationship between a depositary bank and its customer,

³²² ROGERS, *supra* note 11, at 140; A. Brooke Overby, *Modeling UCC Drafting*, 29 Lox. L.A. L. REV. 645, 698 (1996) (noting that "heavy volume and an increasingly mechanized system" has moved banks to limit or eliminate manual inspection).

³²³ See ROGERS, *supra* note 11, at 140.

³²⁴ *Id.*

³²⁵ *Id.*

³²⁶ See *id.*; Overby, *supra* note 322, at 698.

³²⁷ See *Tex. Commerce*, 703 F. Supp. at 594; *Caledonia*, 75 A.2d at 687.

³²⁸ See *Tex. Commerce*, 703 F. Supp. at 594; *Caledonia*, 75 A.2d at 687.

³²⁹ See U.C.C. § 4-202 (2002).

³³⁰ See *Tex. Commerce*, 703 F. Supp. at 594; *Caledonia*, 75 A.2d at 687.

³³¹ See *Tex. Commerce*, 703 F. Supp. at 594; *Caledonia*, 75 A.2d at 687; U.C.C. § 4-401.

separately from the rest of Article 4 with due regard to its history, would create an analogous regulation of a bank's duty to its depositors as to the bank's duty to its credit or debit cardholders.³³² These relationships between banks and account holders are regulated by the Truth in Lending Act (TILA) and the Electronic Funds Transfer Act (EFTA), respectively.³³³ TILA and EFTA only regulate the relationship between an account holder and the issuing bank.³³⁴ The relationship between the network banks for either the debit or credit network, the issuing bank, and the merchant are all governed specifically by standard contract law.³³⁵

Courts should continue to allow the variability of the remaining portions of Article 4, that is, parts I, II, and III.³³⁶ This proposed allocation would allow banks to create agreements with each other to pursue the most efficient methods in check collection, which is separate from the duties that a bank has to its depositors.³³⁷ A collecting bank's only duty is to the previous bank in the chain of collection to proceed with ordinary care to receive final payment of the item; the collecting bank has no duty to the person who originally deposited the check.³³⁸

This new analysis of the relationship between a bank and its depositors would not permit variation of whether items are properly payable under section 4-401.³³⁹ Instead, the analysis would be analogous to Article 4A, governing wire transfers, which does not permit the risk allocation scheme to be varied by agreement.³⁴⁰ Wire transfers are used by similar customers as positive payment systems, presenting an illogical variance in the current law whereby a bank is not liable in the check system for an equivalent action for which it would be liable in the wire

³³² See Truth in Lending Act (TILA), 15 U.S.C. § 1643(a) (2006); Electronic Funds Transfer Act (EFTA), 15 U.S.C. § 1693g(a); U.C.C. § 4-401.

³³³ TILA, 15 U.S.C. § 1601 (providing that the purpose of TILA is to protect consumers from inaccurate and unfair credit billing and credit card practices); EFTA, 15 U.S.C. § 1693 (providing that the purpose of EFTA is to provide individual consumers with substantive rights).

³³⁴ TILA, 15 U.S.C. § 1601; EFTA, 15 U.S.C. § 1693.

³³⁵ See TILA, 15 U.S.C. § 1601; EFTA, 15 U.S.C. § 1693.

³³⁶ See U.C.C. § 4-103 (2002).

³³⁷ See *id.*

³³⁸ See *id.* §§ 4-103, 4-202.

³³⁹ See *id.* § 4-401.

³⁴⁰ See *id.* § 4A-202(f) (stating that the rights and obligations arising under this section cannot be varied, except through section 4A-203(a)(1)); *id.* § 4A-203(a)(1) (allowing receiving banks to limit the extent to which they are entitled to enforce or retain payment of a payment order).

transfer system.³⁴¹ This variation should be rectified by not allowing banks to vary the default provisions of Article 4.³⁴²

This new analysis is more appropriate than the current situation because section 4-103 logically applies to the duties of a collecting bank; collecting banks are free to vary the standard rules of check collection and make different agreements with other banks so long as they maintain their duty of ordinary care.³⁴³ It becomes clearer how much more sense this solution makes when compared with how the concept of lack of ordinary care interacts with the idea of properly payable.³⁴⁴ As mentioned above, the fact that a bank cannot disclaim ordinary care when varying the UCC and the idea that banks can in fact vary section 4-401 such that they can charge depositors for unauthorized items results in a logical quagmire of how to reconcile the notion of not disclaiming ordinary care with the duties of a debtor to a creditor.³⁴⁵ Compared to the applicability of section 4-103 to section 4-401, the application of section 4-103 to the collection provisions is more logical—banks can vary the default rules of collection so long as the collection agreements do not delay collection, and thus do not amount to a lack of ordinary care.³⁴⁶

CONCLUSION

Courts have been willing to enforce agreements that vary section 4-401 of the Uniform Commercial Code and place the risk of loss entirely on depositors rather than the banks that accept forged checks. Due to the creditor-debtor nature of the relationship, this willingness is problematic and should not be supported. Section 4-103 provides that a bank can vary the standard provisions within Article 4 so long as it does not disclaim ordinary care. In the context of a creditor-debtor relationship, what does ordinary care mean? There are two possible answers to this question: either (1) the drafters were looking at deposits in the context of the historical relationship, or (2) most of Article 4 is concerned with the collection of checks and part 4 of the Article was added to the old bank collection statutes without considering how section 4-103 would interact with section 4-401. Either explanation leads to the

³⁴¹ U.C.C. art. 4A prefatory note.

³⁴² U.C.C. art. 4A prefatory note (2002) (stating that the payments governed by Article 4A are primarily between business or financial institutions).

³⁴³ See *id.* §§ 4-103, 4-202.

³⁴⁴ See *Tex. Commerce*, 703 F. Supp. at 594; *Caledonia*, 75 A.2d at 687; U.C.C. § 4-401.

³⁴⁵ See *Tex. Commerce*, 703 F. Supp. at 594; U.C.C. § 4-103.

³⁴⁶ See U.C.C. § 4-202.

same solution: courts should remember the critical context of the depositor-bank relationship when presented with a provision in a deposit agreement that varies a default rule governing that relationship.

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